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FOR ASSISTANT SECRETARY CLAUDIA MCMURRAY

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SUBJECT: SCENESETTER FOR THE VISIT OF ASSISTANT SECRETARY MCMURRAY

¶1. (SBU) The United States Mission in Brazil warmly welcomes your planned December 12-13, 2006, visit to Brasilia. Counselor for Environment, Science, Technology and Health Patricia Norman and OES Advisor Lawrence Sperling will greet you upon your arrival in Brasilia December 12. You are scheduled to hold preliminary meetings for the U.S.-Brazil Common Agenda for the Environment on December 13 and meet with Brazilian officials. In addition, we have scheduled a Country Team meeting shortly after your arrival on Dec. 12 here at the U.S. Embassy to brief you on the current state of affairs in Brazil.

¶2. (SBU) Your visit, scheduled right after President Lula's reelection, comes at a transition point on the political scene. During the second semester of 2005, congressional deputies from Lula's governing coalition were accused of accepting bribes, while officials from the President's party (the PT) were alleged to have engaged in influence peddling and illegal campaign fund-raising. These revelations forced the resignation of several members of Lula's inner circle, including his former Chief of Staff (who was also expelled from Congress). Another scandal that was revealed in September 2006 caused the resignations of several top Lula campaign officials and the head of the PT.

¶3. (SBU) However, Lula was able to surmount all this and win reelection with 61 percent of the vote. He is now mulling his options with regard to which parties his PT banner should ally with in Congress and who to include in his cabinet.

THE BILATERAL RELATIONSHIP

¶4. (SBU) While relations between the U.S. and Brazil are friendly, often the USG encounters major difficulties in gaining the cooperation of senior policymakers on issues of significant interest to the United States. Eager to assert its own influence, the Brazilian government shies away from cooperation with the USG - unless it can clearly be characterized as a reciprocal exchange among equals. Indeed, hyper-sensitivity on issues viewed as infringing on Brazil's sovereignty can get out of hand and may be seen as signs of political immaturity. Many Brazilians believe the U.S. has designs on the Amazon. Our fingerprinting of visitors to the U.S. drew reciprocal treatment for Americans here; visa and immigration issues remain sensitive points.

¶5. (SBU) During recent months, our ongoing dialogue with the Brazilians has focused on a variety of potentially useful projects for both sides. We sought to interest the GOB in a Defense Cooperation Accord, but the Foreign Ministry rejected the proposal even though the Defense Ministry was supportive. Gaining agreement on privileges and immunities to be granted U.S. servicemen engaging in military exercises has been just as tough, as the Foreign Ministry saw it as "a foot in the door" and linked it with Brazil's strong opposition to Article 98 agreements. We are receptive to renegotiation of a stalled bilateral agreement governing space

launches at the country's equatorial base at Alcantara, but the GOB has moved glacially to re-engage, even though the agreement clearly serves Brazilian interests. On trade issues, when unscripted, President Lula has characterized the FTAA as "off his agenda." IPR is another sore point, as it has become clear that the USG and the Brazilian government have different views on the degree of protection to be afforded to intellectual property. Only after much lobbying have we gotten the GOB to: a) turn the corner on copyright piracy, and b) persuaded policymakers to pursue negotiated solutions rather than compulsory licensing of AIDS anti-retrovirals.

¶16. (SBU) However, not all our conversations are difficult. At the personal level, Lula has met President Bush several times and the two have a good rapport. On issues involving matters perceived as technical in nature - i.e., law enforcement and science (but not counter-terrorism) - the GOB is eager to engage. For example, from 2003 to 2004, the GOB worked quietly with us on the timing and details of its shoot-down program to accommodate our statutory requirements. Brazil's Ministry of Health has expressed its desire to expand the collaboration it has with the U.S. Centers for Disease Control and the National Institutes of Health as these agencies work within the Brazilian medical community to bring newer treatments and technologies. The Brazilian Ministry for the Environment has asked the United States for technical support in several key environmental areas that offer us an important opportunity for closer bilateral cooperation.

¶17. (SBU) On development assistance issues, our dialogue is positive - but constrained. Notwithstanding lackluster results to date, the Brazilian government's multi-billion dollar poverty alleviation program -Zero Hunger - receives substantial funding from the World Bank and IDB. Given USG budget constraints and the fact that Zero Hunger is, in essence, a cash transfer program (albeit with conditions), USAID support has been limited. Instead of focusing on

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cash transfers to the poor, USAID has sought to target its efforts towards promoting sustainable livelihoods - inter alia, through working with small and medium-sized enterprises. The Embassy's Public Affairs programs aimed at promoting young leaders take a similar targeted approach. This difference in focus, broad cash transfers versus targeted assistance, ends up putting the USG at the margins of Brazil's overall anti-poverty efforts.

FOREIGN POLICY

¶18. (SBU) Reflecting Brazil's ambivalence towards the United States, President Lula has run an activist foreign policy with a focus on South America and the Third World, seeking to forge alliances with other mid-sized powers (South Africa, India, etc.). He has traveled extensively in pursuit of a higher international profile for Brazil.

Despite prodding from the USG and others, Lula has refused to condemn Cuba for human rights violations and, in fact, has pushed for Cuban membership in the Rio Group. Brazil has also advocated a Cuba-Mercosul trade pact. The GOB has worked to increase both its economic and political ties with Venezuela. It has agreed to upgrade Venezuela from associate membership to full membership status in Mercosul and enhanced integration of the two countries' energy sectors is high on its agenda. Lula has been especially solicitous of Chavez. Lula has praised the Venezuelan President's democratic credentials ("if anything, Venezuela has an excess of democracy") and declared that the Chavez government had been demonized by its foes. However, Venezuela's apparent involvement in Bolivia's recent decision to nationalize that country's oil and gas industry has dulled the luster on this relationship.

¶19. (SBU) Given its size and natural resources, Brazil has long seen itself as the natural leader of the region (even though that perception is not shared by its neighbors). Brazil's reaction to Bolivia's May 2006 nationalization of foreign petroleum installations in that country is a case in point. Shocked that the Bolivians viewed the Brazilian oil parastatal Petrobras as a "boss, not a partner," government policymakers have vacillated in response to President Morales' threats.

¶10. (SBU) Emblematic of Brazil's efforts to gain greater standing on the world stage is its tenacious pursuit of a permanent UN Security Council (UNSC) seat. In fact, many observers point out that Brazil has "subordinated" other economic and political interests with such countries as China and Russia in exchange for support (which has not been forthcoming) for its UNSC aspirations. Brazil and other G4 states (India, Germany, Japan) are, despite recent setbacks, continuing to press their campaign for a vote on a resolution on UNSC reform. This stance is at odds with the position of many Latin American countries, including those which Brazil believes should follow its "natural leadership."

¶11. (SBU) Brazil has long seen international fora as a way to enhance its international stature. Reflecting this, in 2005 it launched failed national candidates for the top jobs at both the WTO and the IDB. The failure of both, together with the unlikely prospects for a permanent seat in the UNSC, has widely been seen in Brazil as a "political disaster."

AGRICULTURE

¶12. (U) Agriculture is a major sector of the Brazilian economy, and is key for economic growth and foreign exchange. Agriculture accounts for 13% of GDP (and 30% when including agribusiness) and 33% of Brazilian exports. Brazil is the world's largest producer of sugar cane, coffee, tropical fruits, frozen concentrated orange juice (FCOJ), and has the world's largest commercial cattle herd (50% larger than the U.S.) at 180 million head. Brazil is also an important producer of soybeans (second to the United States), corn, cotton, cocoa, tobacco, and forest products. The remainder of agricultural output is in the livestock sector, mainly the production of beef and poultry (second to the United States), pork, milk, and seafood.

ENVIRONMENT

¶13. (U) As one of the world's "megadiverse" countries, environmental issues loom large in Brazil. Of the world's known plant species, 22% exist in Brazil, and the figures for birds (17%), mammals (11%), and fish (11%) are also significant. The Amazon basin holds 20% of the world's fresh water. Brazil's Minister for the Environment, Marina Silva, has secured passage of legislation protecting 20 million hectares of land during her administration and she has indicated that Brazil would like to follow the U.S. model and establish public parks on the protected land. Minister Silva has also passed legislation establishing the first Brazilian forest

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service. The U.S. agencies that work with parks in the U.S. are poised to collaborate with Brazil on these issues. Brazil and the United States are also discussing collaboration on the U.S.-sponsored Coalition Against Wildlife Trafficking. Amazon deforestation rates for the period August 2004 to August 2005 reflect a 31% drop, and the GOB is predicting another 11% drop this year. These figures are still affected, however, by the strong expansion in Brazilian agriculture, particularly the drive for land by the cattle and soy industries.

¶14. (U) Internationally, Brazil is an energetic advocate on environmental issues and treaties including the Kyoto Protocol. Yet, for many, the Brazilian government has not met the high and largely exaggerated expectations of many environmentalists during the first years of the Lula Administration. The early 2005 passage of a Biosafety law, representing an opportunity to legalize GMO crops, drew especially strong criticism from environmentalists. The agricultural industry's lobbying for expansion of the transportation network in the Amazon has raised additional concern. As in other policy areas, the Lula Administration is more centrist on environmental issues than much of its devoted, leftist political base expected.

ETHANOL

¶15. (U) The success of Brazil's ethanol program has made it a model for the world in terms of alternative energy. Brazil's comparative advantage is its ability to inexpensively produce ethanol from sugarcane, which has the highest starch content of any plant stock. In addition to obtaining five harvests from one planting, cane hulls (bagasse) are used to produce the thermal energy necessary to power the conversion process. Cane also requires less processing than ethanol produced from corn -- which is the method used in the U.S. to manufacture ethanol. According to the World Bank, at current prices, Brazil can make ethanol for about US\$1 a gallon, compared with the international price of about US\$1.50 a gallon for gasoline.

At the pump ethanol receives favorable tax treatment from the Brazilian government. It is exempted from the largest federal tax on gasoline (CIDE) and is subject to lower rates on two other federal levies (PIS and COFINS). Nevertheless, ethanol prices can vary substantially from state to state. In contrast, gasoline prices tend to vary less and are controlled by the government.

¶16. (U) Since the 1980s, Brazil has attempted, without great success, to promote ethanol fuel exports to the United States. U.S. tariffs and charges make Brazilian imports uncompetitive. In addition to import tariffs of 1.9 to 2.5 percent, the U.S. imposes a 54 cents/gallon charge on ethanol imported for use as fuel. These charges must be paid by countries not covered by FTAs or other trade preference arrangements. Given the requirements of its fast-growing domestic market, whether Brazil will indeed be able to produce enough ethanol to supply international markets is an open question. Some estimate that over the next one to two years, the maximum percentage of Brazil's cane crop which can be devoted to ethanol production is 54%. If so, this would mean that Brazilian ethanol production is already running at 95 percent of capacity; and the country's ability to expand its sugarcane acreage is limited to perhaps 20 percent over the next 3-4 years.

PRESIDENT LULA

¶17. (SBU) President Luiz Inacio Lula da Silva was inaugurated in January 2003 after a career as a Sao Paulo metalworker and labor leader. He founded the left-of-center Workers' Party (PT) in 1980 and lost three presidential campaigns before winning in the October 2002 elections. Lula was reelected with a comfortable margin of victory in October 2006. Elected in large part on promises of promoting an ambitious social agenda, including a "Zero Hunger" program, Lula's government has failed to deliver much in this area, as managerial shortcomings and the public's top concern - crime and public security - have not improved under this administration.

¶18. (SBU) As noted above, in the run-up to the October 2006 election, the Lula Administration was beset by a grave political crisis as interlocking influence peddling/vote-buying scandals plagued elements of Lula's PT party. Indeed, during the second half of 2005, the crisis placed Lula on the defensive and politics were dominated by investigations, accusations and revelations. The President's Chief of Staff resigned his post and was later expelled from Congress. Meanwhile, several other congressmen were the subjects of investigations and expulsion proceedings owing to bribery allegations. In April 2006, the President's influential Finance Minister was forced to resign (and remains under criminal investigation) because of unrelated abuse of power allegations. The revelation of a new scandal shortly before the presidential election

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involving accusations against members of Lula's campaign who were his long-time associates briefly seemed to threaten his reelection prospects, and sent the contest into a second round. But Lula survived the crisis and, supported by millions of poor voters who benefit from federal social spending programs, Lula was reelected.

MACRO-ECONOMIC DEVELOPMENTS

¶19. (SBU) President Lula and his economic team have implemented prudent fiscal and monetary policies and pursued necessary reforms. Brazil's external accounts, aided by a benign international

environment, have improved substantially over the last three years. Although GDP growth dropped to 2.3% in 2005, down from a strong performance (4.9%) in 2004, Brazil has experienced booming exports, healthy external accounts, inflation under control, decreasing unemployment and reductions in the debt-to-GDP ratio. Economic activity should pick up in 2006; the markets expect GDP growth of about 3.0%. Buoyed by exports and investment inflows, the Real has remained at appreciated levels, allowing the government and businesses to pay down external debt. The government pre-paid its IMF obligations, its last remaining rescheduled Paris Club obligations, and in April 2006 announced it had retired the last of its Brady bonds. This removes from the books all restructured debt associated with Brazil's late-1980's default. Based upon the improving external debt dynamics, Fitch IBCA upgraded its credit rating on Brazil's sovereign debt in February 2006, to BB (two notches below investment grade). The economy also has shown resilience, remaining for the most part unaffected by a major political scandal and the replacement of the finance minister.

¶20. (SBU) Despite this considerable progress, key challenges remain. The public sector-debt-to-GDP ratio is on a downward trend but remains high, at about 50%. Real interest rates are among the highest in the world; reducing them will require both reductions in the government's borrowing requirement and reform of the financial sector and the judiciary. Income and land distribution remain skewed. Investment and domestic savings are low, although growing. The informal sector constitutes between 35 to 40 percent of the economy, in part because the tax burden (nearly 38 percent of GDP) is high.

¶21. (SBU) Sustaining high growth rates in the longer term depends on the impact of President Lula's structural reform program and efforts to build a more welcoming climate for investment, both domestic and foreign. In its first year, the Lula administration passed key tax and pension reforms to improve the government fiscal accounts. Judicial reform and an overhaul of the bankruptcy law, which should improve the functioning of credit markets, were passed in late 2004, along with tax measures to create incentives for long-term savings and investments.

¶22. (SBU) Public-Private Partnerships, a key effort to attract private investment to infrastructure, also passed in 2004, although implementation of this initiative still awaits promulgation of the necessary regulations. Labor reform, additional tax reform and autonomy for the Central Bank were on the agenda for 2005 to 2006, but now are unlikely to be addressed at least until the new year begins. Much remains to be done. The government needs to improve the regulatory climate for investment, particularly in the energy sector; to simplify torturous tax systems at the state and federal levels; and to further reform the pension system.

TRADE POLICY -----

¶23. (SBU) To increase its international profile(both economically and politically), the Foreign Ministry (Itamaraty) is seeking expanded trade ties with developing countries, as well as strengthening the Mercosul customs union with Uruguay, Paraguay and Argentina. Arguably the GoB has fallen short on this latter objective. The Brazil-Argentina relationship is rife with trade disputes, recently leading to adoption of a safeguard mechanism for bilateral trade. Meanwhile, Uruguay and Paraguay regularly complain that Brazil and Argentina reap a disproportionate share of benefits from the bloc, and threaten the group's solidarity in various ways -- for instance, Uruguay's recent discussions with the United States regarding a possible FTA (which would contravene Mercosul rules).

¶24. (SBU) Nonetheless, the bloc remains engaged in certain external trade negotiations. In 2004, Mercosul concluded free trade agreements with Colombia, Ecuador, Venezuela and Peru, adding to its existing agreements with Chile and Bolivia to establish a commercial base for the newly-launched South American Community of Nations. As noted earlier, Mercosul is upgrading Venezuela's status from associate to full membership. In addition to Cuba, the bloc is currently exploring free trade talks with Israel, the Dominican Republic, Panama and states of the Gulf Cooperation Council, as well

as trying to build on partial trade liberalization agreements concluded with India and South Africa in 2004.

¶25. (SBU) China, which was offered market economy status by Brazil as a part of Lula's effort to secure PRC support for Brazil's bid for a USNC seat, has increased its importance as an export market for Brazilian soy, iron ore and steel, becoming Brazil's fourth largest trading partner and a potential source of investment. However, low-priced Chinese imports, particularly in the textile, footwear, and toy sectors, are now threatening to displace domestic Brazilian production. As many Brazilian observers have indicated, all this effort is aimed at countries which together represent less than a third of Brazil's foreign trade. Free trade negotiations with the EU continue to languish.

DOHA AGENDA - WTO

¶26. (SBU) While Brazil emphasizes South-South trade through Mercosul's bilateral negotiations, it uses that Doha Development Agenda (DDA) negotiations as the main forum for engaging with developed country partners. The DDA is Brazil's top trade priority, viewed as the last chance for perhaps 15-20 years to secure fundamental changes in international trade rules, in particular, for international agricultural trade. Brazil leads the G-20 group of developing countries that is pressing for agricultural trade reform in the DDA. Brazil's assertive leadership of the G-20 was blamed in some quarters for causing the failure of the WTO Cancun Ministerial in September 2003. Since then, Brazil has been more constructively engaged in the Doha Round, initially as a member of the "Five Interested Parties" and more recently G-6 informal group, although many of its positions are still at odds with U.S. interests. At the December 2005 Hong Kong Ministerial meeting, Brazil was key to brokering the deal - albeit one of limited ambition - coming out of that session. Brazil can be expected to maintain its assertive stance in the Doha Round on agricultural trade reform while taking more defensive postures in the discussions covering industrial products and services.

FREE TRADE OF THE AMERICAS - FTAA

¶27. (SBU) As indicated above, the Lula Administration shows no serious interest in pursuing the FTAA. Despite serving as co-chair and having secured in the November 2003 Miami meeting a new framework for negotiation, Brazil has shown no inclination to move the process along and has so far declined to convoke the next FTAA Ministerial - which is now overdue.

WILLIAMSON